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SUBJECT: Frankfurt Financial Experts Express Pessimism on
Macro-Outlook to OCC

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¶1. Summary: With commodity prices soaring, the euro at an all time high, and financial turmoil in the U.S. in the headlines, worries of a recession and further shocks to the financial system remain high in Germany and Europe. Frankfurt-based financial and macroeconomic experts agree that growth will decline in 2008 and 2009 and profitability will be low in the financial sector. Despite the turmoil, they see little reason to fear a wider banking crisis or an economic shock that would stoke a deep recession. End Summary.

Macroeconomic Growth Prospects Low

¶2. In a July 21-22 visit to Frankfurt, Arthur McMahon, Director for Economic Outlook and Bank Conditions at the Office of the Comptroller of the Currency (OCC), and Geralynn Batista, an OCC economist, spoke with senior economists and financial sector experts at the European Central Bank (ECB), Deutsche Bank and Citibank on current risks to the European banking sector and macroeconomic trends. All sides agreed that current macroeconomic growth prospects in the euro zone were likely to trend downwards due to the rise in euro zone interest rates, the strong euro and rising commodity prices. Several interlocutors argued that the current prospects debunked the myth of "decoupling", whereby Europe's decreasing dependence on the U.S. market would supposedly help it avoid a downturn.

¶3. A Citibank economist predicted euro zone growth for 2008 of 1.8% and 0.9% for 2009 and 1.8% and 0.6% in Germany, figures below those of the ECB which he felt were too optimistic but would eventually be revised down. He predicted a sharper drop in exports, a source of current German economic strength, which would set in as demand fell off in the U.S. and elsewhere. He also drew a corollary between rate rises by the Bundesbank (Germany's central bank) in 1973, 1981 and 1992, which each time led to a recession, and the current rate rise by the ECB. Nevertheless he argued that the ECB would rather "take the hit upfront" than set off a larger crisis in the long term by not fighting inflation.

¶4. A macroeconomic analyst at the ECB highlighted the problem of rising food and oil prices, which negatively affects euro zone consumption and investment. He saw food prices stable in the near term, but doubted oil prices would drop significantly as the increased demand in the developing world would not go away. Senior economists at Deutsche Bank, however, pointed out that all previous attempts to predict oil prices had failed, but there were signs of decreasing demand in the developing world. All sides felt that despite some wage increases, Europe had avoided a wage-price spiral that would set off inflation.

Credit Crunch Unlikely, but Earnings Low

¶5. On the European banking system, experts saw no sign of an impending credit crunch or big surprises from the banks. An ECB financial stability expert said that of the twenty largest, and therefore systemically relevant, European banks only five or six had so far had serious write-downs due to the financial turmoil. He expressed surprise that leverage ratios were not decreasing in European banks, but speculated that banks were most likely moving to higher quality assets. The flight to quality would inevitably mean diminished returns in the near term.

¶6. All sides pointed out that the 14% rise in corporate lending since the beginning of the financial turmoil in August 2007 should allay any fears of a drying up of credit. The Citibank economist, however, ascribed this trend to a lag effect and said the volume would go down in the coming quarter. Many credit lines negotiated before August 2007 are still open to corporations and actively drawn on. However, as these lines expire, new ones will be negotiated with less favorable rates leading to a decrease in volume. With equity prices also low, corporations will have few attractive sources of raising capital.

¶7. The Deutsche Bank economist expressed some pessimism on earnings in the financial sector in the coming months. With so much debt already on the firms' balance sheet, a negative credit cycle of decreased lending was inevitable. Earnings capacity is also diminished by lower demand for services, such as equity issuances. Firms like Deutsche Bank, which is still doing well on its business in the Asia-Pacific region, can count on good earnings, but others will need to search for new business models. He worried about a

regulatory backlash, saying that a rise in capital ratios would have a negative impact on balance sheets.

¶8. Comment: While the mood on the economic outlook among economists and financial sector experts has turned decidedly sour, few expect great shocks ahead. But experts have called several false dawns over the course of the last year in hopes that the worse was behind only to be surprised by further turmoil. Key indicators such as European export figures, euro zone inflation rates and bank quarterly reports will be closely watched in the coming quarters to judge the health of the European economy. End Comment.

¶9. This cable was coordinated with Embassy Berlin and cleared with Arthur McMahon and Geralynn Batista at the OCC.
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